# 15.01 Earnings Per Share: Basic

## Reporting Earnings Per Share

A publicly held company is required to present earnings per share (EPS) for Basic and Dilutive EPS on the **face** of the income statement for (ASC 260):

- **Income from continuing operations (ONT – I)**
- **Net income**

The company must also present EPS for **discontinued operations**, which may be presented **either** on the *face* of the statement or in the *notes* to the financial statements.

A company does not present other Comprehensive income or total comprehensive income on a per share basis. Cash flows per share are also not disclosed.

If a company has only common stock, preferred stock, and other instruments that cannot be converted into common stock (no options or convertible securities outstanding) it has a **simple capital structure** and reports a single EPS number for each of the above categories. If a company has outstanding options or convertible securities, it has a **complex capital structure** and must present two EPS numbers for each of the above categories:

- **Basic**
- **Diluted**

## Basic Earnings Per Share

The calculation of EPS in a simple capital structure (and basic EPS in a complex capital structure) follows. We'll use the calculation of net income for all of these examples.
Earnings per share is, of course, earnings divided by shares:

- **Earnings** = Net income minus preferred stock dividends.
- **Shares** = Weighted average common shares outstanding during the year.

Since EPS is being computed for the **common stock**, earnings must be reduced by dividends payable to preferred shareholders. If the preferred stock is **not cumulative**, only dividends actually declared during the year are subtracted. If the preferred shares are **cumulative**, the annual dividend preference is subtracted each year, regardless of whether or not it is declared or paid, since the amounts not paid accumulate and will never be payable to common shareholders. The effect of participating preferred shares is more complicated and appears to be beyond the scope of CPA exam testing.

### Simple (Basic) Capital Structure

Net Income
– Preferred Divs (All Cumulative and Noncumulative only if declared)
$ Available to C/S
___
(1) Wtd avg. # C/S outstanding (divs and splits – Retroactive)

As an example of the computation of earnings for EPS purposes, assume a company has the following capital structure:

| | |
|---|---|
| 8% Preferred stock | $400 |
| Common stock | 100 |

The company reports net income of $932 for the year and declares no dividends. If the preferred stock is not cumulative, common stock earnings are $932. If the preferred stock is cumulative, then the missed dividend of $400 × 8% = $32 accumulates and will be paid to the preferred shareholders eventually, reducing the earnings applicable to common stock to $932 – $32 = $900. It doesn't matter if there are dividends in arrears from earlier years, since those amounts would have been subtracted in determining EPS of those earlier years, and wouldn't be subtracted again this year.

## 1 - Weighted Average Number of Common Stock Shares Outstanding

The determination of the **number of shares** to include in the denominator of the calculation can be very tricky. The amount to be used is the weighted average of the number of common shares outstanding during the year. As a result, shares sold to the public during the year must be prorated for the portion of the year they were outstanding.

For example, assume the following facts applied to the client for the first two years of its existence:

| | |
|---|---|
| Issued, 1/1/X1 | 500 |
| Issued, 7/1/X1 | 100 |
| Issued, 10/1/X1 | 300 |
| Outstanding, 12/31/X1 | 900 |

Although the number of shares outstanding at 12/31/X1 is 900, only 500 of these shares (those issued at the start of 20X0) were outstanding throughout 20X1. The 100 shares issued on 7/1/X1 were only outstanding for half of the year, and the shares issued 10/1/X1 for the final quarter of the year. The calculation of weighted average shares for 20X1 is:

| | |
|---|---|
| 500 × 12/12 = | 500 |
| 100 × 6/12 = | 50 |
| 300 × 3/12 = | 75 |
| Total | 625 |

The reason for prorating shares issued during the year is that the funds received from issuance are only available for productive use by the corporation from that point on, not the entire year. This would **not** be the case, however, if shares are issued as a result of (**Retroactive**):

- Stock dividends
- Stock splits
- Delayed issuance for earlier consideration (Stock Subscriptions)

In these cases, the shares are treated as if they had always been outstanding and are included at full amount for the current year. They are also included for earlier years that are shown in *comparative financial statements*. In the case of a reverse stock split, these would retroactively *reduce* shares outstanding for all periods presented.

For example, assume that the 100 shares issued on 7/1/X1 were the result of a 20% stock dividend on the 500 shares outstanding previously. Since all shares are going to previous shareholders, they are treated as if they always had these additional shares. The calculation for 20X1 is:

| | |
|---|---|
| 500 × 1 = | 500 |
| 100 × 1 = | 100 |
| 300 × ¼ = | 75 |
| Total | 675 |

On 1/1, 100,000 shares of C/S are outstanding. On April 1st, 80,000 shares are issued. On July 1st, a 10% stock dividend is issued. On September 1st, 18,000 shares of Treasury Stock are repurchased. On December 31st a 2 for 1 stock split occurs. Calculate the weighted average number of shares of C/S outstanding at 12/31.

| | |
|---|---|
| 1/1 100,000 shares o/s × 100% = | 100,000 |
| 4/1 80,000 shares issued × 9/12 = | 60,000 |
| 7/1 10% dividend issued 160,000 × 10% = | 16,000 |
| 9/1 18,000 shares of Treasury Stock repurchased × 4/12 = | (6,000) |
| | 170,000 |
| 12/31 at 2 for 1 stock split occurs | × 2 |
| Weighted average number of C/S outstanding at 12/31 = | **340,000** |